

87-SBE-028

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
DYNATECE FLUID TECHNOLOGY) No. 84R-1356-VN
CORPORATION, FORMERLY P M)
AMERICA, INC.)

Pot Appellant: Suren G. Dutia
President

Pot Respondent: Alison M. Clark
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Dynatech Fluid Technology Corporation, formerly P M America, Inc., for refund of franchise tax in the amount of \$21,077.58, including penalty, for the income year ended July 31, 1980.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

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Appellant Dynatech Fluid Technology Corporation was the successor corporation of P M America, Inc. (PMA), having acquired PMA's assets and business sometime after the income year in question.² The issue presented for our decision is whether appellant is entitled to a bad-debt deduction for advances that PMA made in 1979 to a new company.

In 1979, PMA was engaged in the business of marketing medical equipment and instruments from its business office in Sacramento. PMA also had an agreement with Hewlett-Packard to sell that company's equipment under a "quantity discounts. arrangement. (App. Br. at 2.) At a meeting on July 26, 1979, the board of directors of PMA was advised that certain individuals were forming a new corporation to develop software with medical applications that was to be compatible with Hewlett-Packard hardware. Believing that production of the software would help increase PMA's sales of Hewlett-Packard equipment and thus improve its earnings under its contract with Hewlett-Packard, the board authorized PMA's president to work with the new company and provide it with loans of company funds to help create the software. PMA also had an option to purchase stock in the company that was to be formed, but the board indicated in the minutes of the meeting that it did not want an ownership interest in the corporation at the time.

On November 15, 1979, the new company was incorporated as Northwest Software, Inc.. (NSI). The principal business activity of NSI was to be the development and marketing of "blood gas software." (App. Br. at 2.) The president of PMA became the concurrent president of NSI and the two corporations shared the same business address as well. The new corporation was to be managed by three individuals comprised of a software programmer, a computer salesman from Hewlett-Packard, and a sales manager. Each member of this management team was to invest in the corporation by purchasing NSI stock. The company, however, never issued any stock.

Between January and July of 1980, PMA advanced \$147,352 to NSI to help the new corporation start its

²/ Appellant was acquired by, and merged into Cooper-Biomedical, Inc., on April 2, 1985, after the appeal year.

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operations. These advances were used by **NSI** to pay wages and payroll expenses, purchase inventory, provide expenses for **salesmen**, and fund the development of software. On their separate **books and** records, PMA treated the advances as loans under its accounts **receivable** ledger while **NSI** recorded the advances **as** liabilities under accounts payable. The parties did not execute any promissory notes. PMA also made the advances to **NSI** without obtaining any security.

In late July 1980, **PMA** learned that **NSI** had severe financial and operational problems. **The company** had yet to make a profit, having experienced losses since its inception. **NSI** had not developed any software products and did not expect to complete production of any software in the foreseeable future. While it had obtained a license to distribute the software created by an independent programmer, **NSI** had not received any finished software from him. Moreover, **NSI salesmen** found that there was **very** small demand for its medical software and the few software packages that they had sold were defective. Due to the many problems faced by **NSI**, its three managers refused to invest in the company. **Consequently**, to limit its own losses, PMA assumed control of the administrative functions of **NSI**, **such** as accounting, purchasing, and sales. By the end of 1981, **NSI** ceased **doing** business, PMA did not receive repayment of its advances.

On January 15, 1981, **PMA** filed its franchise tax return for the income year in question, but failed to pay the \$14,857 in tax due. Shortly **thereafter**, upon advice of its auditors, PMA decided to treat the advances to **NSI** as uncollectible debts in the appeal year. On June 2, 1981, PMA filed an amended return, claiming a deduction of **\$150,695** for an addition to its bad-debt reserve which reduced its outstanding tax liability for the appeal year to \$200. Upon review, the Franchise Tax Board disallowed the claimed deduction. Subsequently, PMA paid **\$21,077.58** in tax, interest, and penalty, but filed a claim for refund. Respondent's denial of the refund claim led to this appeal.

In support of its disallowance of the bad-debt deduction, the Franchise Tax **Board** contends that the advances made to **NSI** were contributions to capital rather than loans. As such, respondent argues, the loss **resulting** from the failure to recover the advances cannot be characterized as a bad-debt loss. In the alternative,

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respondent urges that, even if the advances **are** found to have been loans, then appellant has not only failed to establish that the debt became worthless during the income year under appeals but also has made an improper retroactive addition to its bad-debt reserve. Appellant contends that the advances constituted loans which **PMA** expected **NSI** to repay from the proceeds of the sale of software.

Section 24348 allows as a deduction any debt which becomes worthless within the income year, or, in lieu of a deduction of a specific debt, a deduction for a **reasonable** addition to a **reserve** for bad debts. Section 24348 is substantially similar to section 166 of the **Internal** Revenue Code. **Federal** precedent is, therefore, persuasive in the proper **interpretation** and application of the California statute. (Meanley v. McColgan, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942).)

In **order** for a debt to be deductible under section 24348, it must be a bona fide debt; that is, one that **arises** from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money, .-(Treas. Reg. § 1.166-1(c).) A deduction may not be taken for an advance **which was** made with **no** intention of enforcing payment (Hayes v. Commissioner, 17 B.T.A. 86 (1929)) or where there was no reasonable expectation of repayment when it was made (Arrighi v. Commissioner, 73 T.C. 792, 799 (1980)). In **addition**, the debt must have become **worthless** in the **taxable** year for which the deduction is **claimed**, (Redman v. Commissioner, 155 F.2d 319 (1st Cir. 1946); Messer Co. v. Commissioner, 57 T.C. 848, 861 (1972).)

A **contribution** to capita&is not considered a debt **for** purposes of the bad-debt deduction. (Treas. Reg. § 1.166-1(c).) Whether advances to a corporation represent capital contributions **or** loans is a question of fact to be determined from all of the facts and **circum-**stances with the taxpayer bearing the burden of proof. (Matthiessen v. Commissioner, 194 F.2d 659 (2nd Cir. 1952); Dunmire v. Commissioner, ¶ 81,372 T.C.M. (P-H) (1981).) **When** distinguishing debt from equity, the courts have relied on the presence of a number of criteria, including: (1) The formal **indicia** of debt, such as the presence of promissory notes or other documents showing indebtedness, the existence of a fixed maturity date, and the bookkeeping treatment of the

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transactions: (2) the efforts to enforce payment of principal and interest; (3) participation in management as a result of the advances; (4) the intent of the parties; (5) adequacy of capitalization in relation to debt; (6) identity of interest between creditor and stockholder; (7) the **ability** of the corporation to obtain loans from outside lending institutions; and (8) the risk of **nonrepayment**. (See Estate of **Mixon v. United States**, 464 F.2d 394, 402 (5th Cir. 1972); Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3rd Cir. 1968).) **How-**
ever, no single criterion nor any series of **criteria** can provide a conclusive answer to whether advances are loans. (See John Kelly Co. v. Commissioner, 326 U.S. 521, 530 [90 L.Ed. 278] (1946).) These various factors are merely aids in answering the significant inquiry, whether the funds were advanced with **reasonable expecta-**
tions of repayment regardless of the success of the business or were invested as risk capital subject to the fortunes of the corporate venture. (Gilbert v. Commissioner, ¶ 56,137 T.C.M. (P-H) (1956), 248 F.2d 399 (2nd Cir. 1957), on remand, ¶ 58,008 T.C.M. (P-H) (1958), **affd.**, 262 F.2d 512 (2d Cir.), cert. den., 359 U.S. 1002 [3 L.Ed.2d 1030] (1959); Fin Hay Realty Co. v. United States, *supra*, 3398 F.2d at 691.)

Applying the above principles to the appeal before us, we are convinced that the advances made by PMA were contributions to capital. First, the advances lacked any of the formal indicia of indebtedness. While both PMA and NSI may have treated the transactions as loans on their respective account ledgers, the parties did not execute any notes or instruments showing interest rates, maturity dates, or repayment schedules. Moreover, there is **no** evidence that PMA even attempted collection of the advances from NSI. In response, appellant has only stated that no one was willing to sign a promissory note and that interest did not accrue due to the improbability of collection. Here, the absence of any formal indicia suggests that there was no debt.

Second, appellant contends that the alleged loans from PMA were "secured" and would be repaid since NSI had plans to develop blood gas software and had acquired a license to distribute other software. The fact of the matter is that PMA made advances to help start **a new enterprise and the advances were made without** any security agreement. It is unlikely that an objective, independent creditor would have made similar unsecured loans. Moreover, since its president held the

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same executive position in NSI, PMA should have been aware that the company was not otherwise capitalized and **was using** the advances to meet the daily requirements of the business. Under such circumstances, it is not reasonable **for** PMA to have expected repayment of the advances in the absence **of NSI's** success.

Third, appellant argues- that **PMA** intended to create a debtor-creditor relationship with NSI. Appellant explains that **PMA**, at that time, had already started merger discussions with Dynatech Fluid Technology Corporation and wanted to diligently avoid purchasing an equity interest in the new company in order to facilitate completion of those negotiations. The problem with this **argument** is that **PMA** had at the outset a direct role and monetary interest in the formation of the corporation. **PMA's** president served NSI in the same capacity and its advances were the only source **of funds for** the new company whose products **PMA** hoped would increase its own sales revenue. Where, as here, advances are necessary to commence a new enterprise, a strong inference arises that the funds were capital **investments** not loans. (American-LaFrance-Foamite Corporation v. Commissioner, 284 F.2d 23 (2d Cir. 1960), cert. den., 365 U.S. 881 [6 L.Ed.2d 192] (1961).) Finally, the fact that **PMA** took control of the management of NSI to avoid additional losses when it was apparent that the corporation was a failure further indicates to us that **PMA had** an ownership **or equity** interest in the **company by** virtue of the advances. ^{3/}

Based on the foregoing, we must conclude that appellant has failed to carry its burden of proving that the advances **were loans**. Accordingly, we must sustain respondent's action in disallowing the claimed bad-debt deduction for the income year in question.

^{3/} Since we find that the advances were **capital contributions** and not bona fide debts, it is not necessary to discuss the worthlessness issue or whether appellant made a retroactive addition to its bad-debt **reserve**.

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